INTERNATIONAL MONETARY FUND

2006 Article IV Consultation with the United States of America

Concluding Statement of the Fund Mission
(May 31, 2006)

1. ***Over the past year, the U.S. economy remained a key engine of global growth, and many of the risks that we and other forecasters had cautioned about have not materialized***. Activity has remained robust, supported by strong productivity growth, strengthening investment, and employment gains. On the fiscal front, revenues continued to surge and spending pressures have been contained, likely keeping the FY 2006 federal deficit at 2½ percent of GDP, well below initial budget estimates. This performance is particularly impressive given significant economic headwinds over the past year, including rising oil prices, the hurricanes that devastated the Gulf coast, and higher interest rates.

2. ***Against this background, we broadly share the Administration's and the Federal Reserve's generally favorable macroeconomic outlook for 2006 and 2007***. GDP growth is projected to ease to a more sustainable rate as the effects of a cooling housing market, as well as higher fuel prices and interest rates on household spending, is partially offset by strength in business investment. We also anticipate that solid productivity growth and well-anchored expectations will keep price pressures contained.

3. ***We also share a common understanding of the critical challenges that still need to be faced to support the goals laid out by the IMFC communiqué in April***. These goals included achieving economic prosperity through strengthened economic policies, addressing global imbalances, and resisting protectionism. Achieving these goals is a shared responsibility, but U.S. leadership in three areas will be critical:

- ***Sustaining growth with low inflation.*** Although the outlook is positive, the challenge is to steer a course between the downside risks to activity stemming from a cooling housing market with possible inflationary pressures from low unemployment and high oil prices.

- ***Addressing external imbalances***. There is broad agreement that the large U.S. current account deficit, and its counterparts abroad, cannot be sustained indefinitely. Although a gradual adjustment is the most likely outcome, delaying progress increases the risk of fanning protectionist sentiment or disorderly foreign exchange market conditions.

- ***Ensuring fiscal sustainability.*** The Administration has taken the welcome step of acknowledging the need for reforms to address the long-term sustainability of entitlement programs, and has also made encouraging progress toward deficit reduction. However, entitlement reform seems to have stalled and there remains a case for setting a more ambitious medium-term deficit objective.

Monetary Policy and Sustaining the Expansion with Low Inflation

4. ***The Federal Reserve has thus far been highly successful in maintaining price stability as the expansion has matured***. As activity has recovered, the Fed has appropriately withdrawn monetary stimulus in a gradual manner that has avoided disrupting financial markets and the expansion. At the same time, the Fed has been remarkably effective in maintaining the credibility of its commitment to price stability, keeping inflation expectations and core inflation anchored in the face of the large shock to energy prices.

5. ***Looking forward, however, interest rate decisions will become more finely balanced***. With the economy now roughly at full employment and the federal funds rate in a more neutral range, the challenge will be to steer a course that manages competing risks. On the one side, an unwinding of the housing boom, low household savings, and higher energy prices could weigh on the expansion. At the same time, however, there are signs that labor markets are tightening, oil prices remain high, and productivity could surprise on the downside, so inflation risks may be tilted to the upside. Especially reflecting the recent pick up in core inflation, and given the importance of keeping inflation expectations in check, the Federal Open Market Committee has appropriately cautioned that some further policy firming may yet be needed.

6. ***The Fed's communications strategy in recent years has been highly effective***. This has been illustrated by the success in forestalling deflation pressures and subsequently engineering an orderly withdrawal of unprecedented monetary stimulus. Looking forward, we continue to believe that quantifying an inflation objective could help further anchor inflation expectations and would be fully consistent with the Fed's broader mandate. Providing more frequent *Monetary Policy Reports* with a greater focus on future developments could also further increase the Fed's high level of transparency.

Reducing External Imbalances

7. ***The ease with which the United States has financed its record current account deficit has been remarkable, but is unlikely to be sustained indefinitely***. A number of (possibly temporary) factors, such as short-term interest rate differentials and increasing demand for long-term bonds, have helped support the U.S. current account deficit and dollar over the past year. However, most forecasters project that the current account deficit will rise further in coming years, which may begin to strain the global appetite for U.S. assets. Delaying the inevitable multilateral adjustment will mean continued increases in U.S. external indebtedness, magnifying the potential for disruption to exchange rates, financial markets, and growth, both domestically and abroad.

8. ***Firm and vigorous implementation of the cooperative strategy laid out by the IMFC last April would support an orderly resolution to global imbalances, and the Fund will use its new remit for multilateral consultations toward this goal*.** The United States has a major role to play in addressing this shared responsibility, and its main task remains to boost national saving, including by more ambitious fiscal consolidation.

9. ***Leadership by the United States remains key to global trade liberalization.*** With progress slowing in the Doha Round negotiations, continuing U.S. commitment and initiative are essential to generate new momentum for a timely and ambitious conclusion. It also remains imperative to resist protectionist responses to global imbalances, particularly as restrictions on trade risk creating significant harm to the global economy. As we have long cautioned, the growing number of bilateral trade initiatives by the United States and others could undermine the multilateral trade system, and there would be merit in seeking agreement on common disciplines.

Putting Fiscal Policy on a Sustainable Path

10. ***As highlighted in the Budget, demographic and other pressures threaten both fiscal sustainability and the nation's future prosperity.*** Spending on Social Security, Medicare, and Medicaid currently account for over two-fifths of federal spending and is rising at an unsustainable rate. While there is no doubt that entitlement reform is essential for achieving a sustainable fiscal position, recent CBO analysis illustrates that even significant entitlement reforms and cuts in other spending may not be sufficient to accommodate the increased demands from an aging population, particularly on public health systems.

11. ***With the Administration indicating that it will achieve its objective of halving the deficit earlier than anticipated, the time is opportune to establish a more ambitious medium-term fiscal anchor.*** There will soon be the need to define a new objective consistent with the Administration's longstanding commitment to deficit reduction. With revenues continuing to be buoyant, we would again propose a target of balancing the budget excluding the Social Security surplus over the next five years. Such an objective would place the U.S. federal debt-to-GDP ratio on a clear downward path and reduce the burden on future generations, while providing the room needed to develop and phase in reforms of health and retirement systems. This would require consolidation at a rate of around ¾ percentage point of GDP a year, which would ease the burden on the Fed for keeping economy close to capacity while raising national saving and reducing global imbalances.

12. ***We agree that expenditure discipline should remain central to deficit reduction, but revenue measures cannot be ruled out.*** To be sure, there has been some success in slowing the growth of outlays, but the Budget projects that the federal deficit will remain around 2½ percent in FY 2007, roughly unchanged in three years despite the strong economic expansion. This suggests some risk that the deficit reduction that is projected in subsequent years may be difficult to attain, especially since it does not take account of ongoing operations in Iraq and other fiscal pressures on revenues and outlays. Thus, action on both sides of the ledger may be required:

- On the expenditure side, entitlements and defense commitments limit the room for cuts, and the Budget already assumes that the ratio of discretionary spending to GDP will be reduced to unprecedented lows over the next five years. Indeed, recent Congressional debate over emergency appropriations underscores how difficult it will be to contain discretionary spending. Although budget rules cannot substitute for an underlying commitment to fiscal discipline, this suggests that there would be merit in re-introducing caps on discretionary outlays and pay-as-you-go (PAYGO) requirements, which had been successful during the fiscal consolidation in the 1990s. However, it would also seem prudent to extend the PAYGO rules to include the impact of tax measures, as was the case under the 1990 Budget Enforcement Act.

- On the revenue side, the significant reductions in marginal tax rates in recent years have supported economic efficiency. Although it may be difficult to sustain these tax cuts while meeting the fiscal burden from population aging, the priority should be on reforms to broaden the revenue base. The President's Advisory Panel offered useful suggestions along these lines, but consideration could also be given to consumption-based indirect taxes—such as a national sales tax, a VAT, or energy taxation—that would maintain revenue buoyancy as workers retire.

13. ***The momentum for entitlement reform needs to be re-invigorated:***

- In the case of Social Security, relatively modest changes in the system could be introduced in a phased manner to put it back on a sustainable basis. The Administration's support for "progressive price indexation" has been helpful, as have other suggestions for increasing the retirement age and the caps on the Social Security payroll tax. Unfortunately, these do not appear to have gained political traction, and the challenge now is to form the necessary consensus to carry reforms forward.

- The financial shortfall of the Medicare system dwarfs that of Social Security, especially with the recent addition of a drug benefit. Administration efforts to promote high-deductible health plans and other measures could help promote greater price consciousness among some consumers. However, given the size of the uninsured and elderly populations as well as total health care outlays that are already twice the OECD average as a share of GDP, more fundamental reform may still be needed.

Preserving Financial Stability

14. ***The U.S. financial sector has proven resilient and innovative in recent years, and appears well-positioned as the credit cycle turns***. While the banking sector is well placed to cope with vulnerabilities stemming from household and corporate borrowing, the decision to issue draft guidance on nontraditional mortgages was appropriate. Conditions in markets for credit derivatives—which have yet to experience a full credit cycle—will also need to be monitored closely.

15. ***There remain, however, important areas where further reform could help enhance the financial system's resilience and efficiency:***

- Action is still needed to carry forward the Administration's proposals to strengthen the supervision of the housing government sponsored enterprises (GSEs) and limit the size of their balance sheets so as to contain systemic risk in mortgage markets.

- Given the growing liabilities of the Pension Benefit Guarantee Corporation, action is needed on proposals to improve its funding and establish risk-based premiums. Welcome steps appear to be in train to avoid discouraging "opt in" provisions in defined contribution plans, which would help encourage retirement saving.

- Supervision and regulation of insurance companies is fragmented and steps to establish a more uniform approach would be welcome.

- Helpful proposals have been made to streamline bank regulation, but important questions have been raised about the appropriateness of relaxing restrictions on the ability of industrial loan companies to accept retail deposits and branch nationwide.

- Publishing a regular *Financial Stability Report* and undertaking a Fund Financial Sector Assessment Program could provide further insights on these challenges.